**Before the**
**FEDERAL COMMUNICATIONS COMMISSION**
**Washington, DC 20554**

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| In the Matter of | ) | |
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| Federal-State Joint Board on Universal Service | ) ) | CC Docket No. 96-45 |

**WESTERN WIRELESS REPLY COMMENTS ON REFORM OF THE RURAL HIGH-COST SUPPORT SYSTEM**

Western Wireless Corporation ("Western Wireless") submits its Reply Comments on the Joint Board's Public Notice regarding reform of the high-cost universal service support mechanisms for carriers serving rural areas. 1/ Western Wireless and other parties, including CTIA, Dobson, and Nextel, have offered creative and constructive ideas for reforming the rapidly growing rural high-cost funding system, and Western Wireless has provided extensive economic analysis in support of its proposals – including a new analysis submitted with these reply comments entitled "*Reforming Universal Service for Rural ILECs: An Idea Whose Time Has Come,*" conducted by Economics and Technology, Inc.

By contrast, the rural ILECs commenting in this proceeding offer no solutions at all to the urgent problems besetting the high-cost fund, and they provide little or no valid economic analysis in support of their positions. To the contrary, they merely argue for continuation of the *status quo* – the corporate

1/ Public Notice, "Federal-State Joint Board on Universal Service Seeks Comment on Certain of the Commission's Rules Relating to High-Cost Universal Service Support," 19 FCC Rcd 16083 (Jt. Bd. 2004) ("*Public Notice*").

welfare system known as rate-of-return regulation, which itself is the root of the fund-growth problem. The rural ILECs have nothing to offer but a non-solution: short-changing rural consumers by imposing anti-competitive restrictions on the funds disbursed to competitive ETCs, which amount to only 7% of high-cost funding during 2004 and account for only 14% of the high-cost fund growth over the past five years. The Joint Board should reject this anti-consumer and anti-competitive approach, and instead should proceed to reform the rural high-cost support system by targeting funds to consumers in the rural areas that need it most using a methodology based on *actual costs – i.e.,* forward-looking economic costs.

1. *Comprehensive Reform of the Rural High-Cost Support System Is Needed Now*. The Joint Board knows better than to follow the advice of the parties who suggest that the rural ILEC funding system "ain't broke, so don't fix it," 2/ or who argue that reform of rural universal service should be deferred in favor of other priorities, such as intercarrier compensation reform. 3/ These parties ignore the obvious and urgent need for reform of the high-cost funding system. The Wireline Competition Bureau recently announced a contribution factor for the first quarter of 2005 of **10.7 percent** – and this comes after emergency legislation, passed at the end of a lame-duck session of Congress, to exempt the fund from certain federal accounting rules in order to forestall even larger increases in contribution rates. Quite simply, the growth of funds going to rural ILECs – in the multi-billions of

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2/ USTA Comments at 3; *see also, e.g.,* Western Telecommunications Alliance Comments at 10; NECA at 2, 5.

3/ *See, e.g.,* AT&T Comments at 3-7.

dollars (orders of magnitude greater than the relatively modest amounts of increased funds to competitive ETCs) 4/ – is out of control. And this growing funding burden imposes serious economic harm upon telecommunications consumers and carriers across the country. 5/

Moreover, rather than following AT&T's advice to shelve universal service reform pending intercarrier compensation reform, policymakers should insist that any form of intercarrier compensation reform be accompanied by comprehensive universal service reform, which would address the fund growth problem and develop a rational and "unified" high-cost support system. Not only does the intercarrier compensation reform proposal favored by AT&T fail to resolve the fund growth problem, it would make the problem far worse. 6/ It would be irresponsible for the Joint Board to do nothing, as AT&T and some ILEC commenters suggest.

2. *Support Based on Rate-of-Return Regulation Creates Incentives for Inefficiency, Waste, and Abuse*. More fundamentally, the Joint Board must grapple with the serious problem posed by the current system's strong incentives for inefficient rural ILEC operations – a problem that is simply ignored by the ILEC

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4/ Western Wireless Comments at 7-9.

5/ These harms are discussed in greater detail in the attached economic analysis by Economics and Technology, Inc., *Reforming Universal Service for Rural ILECs: An Idea Whose Time Has Come*, Exh. A to this reply comment ("*An Idea Whose Time Has Come*"), at 14-16.

6/ The Intercarrier Compensation Forum ("ICF") recently disclosed that, under their plan, the two newly created universal service subsidy mechanisms would add $1.126 billion annually to the high-cost fund in the first year after the plan is implemented and would add $2.669 billion annually by the fifth year. *Ex Parte* letter from Richard R. Cameron, Counsel to the ICF, to Marlene Dortch, FCC, CC Docket No. 01-92 (filed Dec. 6, 2004). This would increase the current high-cost fund (disbursing approximately $4.0 billion per year) by more than 50%.

commenters. 7/ Rather than targeting funds to the rural areas and consumers that need them, the current system disburses funds to the carriers that have spent the most – a system that, as the Commission has long understood, interferes with incentives for carriers to operate efficiently and discourages them from introducing technological innovations. 8/ Moreover, the current high-cost funding system for rural ILECs is highly susceptible to waste and abuse, but – unlike the schools and libraries funding mechanism – has not been thoroughly audited and is barely subject to any independent oversight. "In an era of corporate governance problems and accounting depredations, this Commission has an especially high burden" of responsibility to establish and enforce safeguards 9/ – or better, to abolish the system that creates the opportunities for such misconduct.

It is understandable that many of the ILECs fear a future without rate-of-return revenue guarantees. But the Joint Board cannot take too seriously these parties' contention that the current embedded cost-based system is the only way to generate "sufficient" funds to ensure sufficient telecommunications service

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7/ Some commenters contend that the existing system provides incentives for investment in high-cost rural areas. *See, e.g.,*, GVNW Comments at 9; Fred Williamson Comments at 9. But a more narrowly targeted plan would sharpen such investment incentives and target them to the highest-cost areas.

8/ *Policy and Rules Concerning Rates for Dominant Carriers*, Further Notice of Proposed Rulemaking, 3 FCC Rcd 3195, 3218-28 (1988); *Policy and Rules Concerning Rates for Dominant Carriers*, Report and Order and Second Further Notice of Proposed Rulemaking, 4 FCC Rcd 2873, 2889-90 (1989); *Price Cap Performance Review for Local Exchange Carriers*, 10 FCC Rcd 8961, 8973 (1995). *See also National Rural Telecom Association v. FCC*, 988 F.2d 174, 178 (D.C. Cir. 1993).

9/ *Section 272(f)(1) Sunset of the BOC Separate Affiliate and Related Requirements*, 18 FCC Rcd 10194 (2003), Separate Joint Statement of Commissioner Michael J. Copps and Commissioner Jonathan S. Adelstein, Concurring.

for rural America. 10/ To the contrary, rural ILEC investors' actual behavior in the marketplace proves that the current system appears to be dramatically over-funding rural ILECs, as demonstrated in the attached economic analysis by Economics and Technology, Inc. Investment data shows that publicly-traded rural ILEC stocks generate returns – measured based on market-to-book ratios, *i.e.*, expected "economic rents" in excess of "fair return" on the net book value of the investment – far in excess of those of Bell operating companies. This excessive return is not due to a higher degree of risk faced by rural ILEC investors – to the contrary, the analysis of investment data demonstrates that these stocks are significantly *less* risky than other investments. 11/ These data indicate that investors have an expectation that rural ILECs will receive funding from the current universal service system and other subsidy mechanisms far in excess of the amounts indicated by book costs.

3. *The Arguments Against a System Based on Forward-Looking Economic Cost Are Easily Refuted*. The rural ILECs who oppose a transition to a high-cost support system based on forward-looking economic costs, by contrast to the extensive economic analysis supplied by Western Wireless and other competitive ETCs, have submitted almost no economic analysis in support of the

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10/ *See, e.g.,* John Staurulakis, Inc. Comments at 12 (embedded cost-based system is the method that "most clearly satisfies" the statutory mandate of sufficiency); Fairpoint Communications Comments at 11-12 (FLEC has a tendency to underestimate costs).

11/ *An Idea Whose Time Has Come* at 2-5. Data on premiums paid when small entities purchase exchanges from larger ILECs also reveal that investors are willing to pay significant premiums over book value. *Id.* at 5-7.

current embedded cost-based system. The one economist who has testified on their behalf submitted evidence that is remarkably thin and easily refuted. 12/

Instead, these parties rely on knocking down a "straw man" – they mistakenly suppose that the only way to estimate forward-looking costs is via the existing Synthesis Model, and they incorrectly contend that the model cannot be applied to rural ILECs. But economic models are not the only way to estimate forward-looking economic costs. Western Wireless has suggested an alternative estimation methodology that relies on adjusting the booked costs of existing ILEC plant to reflect the difference between past and present installation costs. 13/

Moreover, it is simply wrong to state, as so many of the rural ILECs do, that economic models such as the Synthesis Model, used for estimating forward-looking costs, inherently cannot be applied to rural ILECs. Many of the rural ILECs rely heavily on a study authored primarily by rural ILEC consulting firm GVNW and published by the Rural Task Force in September 2000 as "White Paper #4," 14/ but some of the analysis in this four year-old paper does not hold up to current scrutiny. For example, the paper makes much of the fact that a run of the

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12/ *See An Idea Whose Time Has Come* at 12-14 (demonstrating that Dr. Dale Lehman, in contending that embedded and forward-looking cost models generate similar results, ignores market realities and relies upon contrived assumptions that are patently wrong). *See also* Economics and Technology, Inc., *Striking a Nerve: ETI's Rejoinder to the NTCA/OPASTCO False Premises Report* (Exh. 4 to Western Wireless Comments, filed Oct. 15, 2004).

13/ Western Wireless Comments at 25-27.

14/ "A Review of the FCC's Non-Rural Universal Service Fund Method and the Synthesis Model for Rural Telephone Companies," Rural Task Force White Paper 4 (Sept. 2000) ("*White Paper #4*). A number of rural ILEC commenters rely heavily on this paper: *see, e.g.,* ACS of Alaska, Inc. Comments at 11, n.20; Alexicon Comments at 6-7; Fred Williamson Comments at 13-14; GVNW Comments at 8, n.2; Fairpoint Communications Comments at 7; NECA Comments at 13, n.37; OPASTCO Comments at 10, n.22.

Synthesis Model generated incorrect line counts and incorrect estimates of wire center areas for many rural ILECs. 15/ But line counts and wire center areas are *inputs* of the model, not outputs, and there is no reason to think that accurate inputs could not be obtained (for example, from the ILECs themselves). The paper criticizes the Synthesis Model for generating network configurations that, in some cases, are significantly different from some rural ILECs' actual networks. 16/ But it provides no evidence on whether the existing networks are efficiently engineered or that the costs incurred to construct them were prudent (indeed, it never asks the question). Similarly, the paper is critical of the amounts of support generated by applying the non-rural ILEC "model-based support" methodology to rural ILECs; 17/ but no one is suggesting that an identical methodology be used to calculate support amounts based on cost estimates in rural ILEC areas. Indeed, the FCC itself identified some of these issues and rejected the conclusions that the rural ILECs attempt to draw from this paper:

> Many commenters representing the interests of rural telephone companies argue that the Rural Task Force's analysis conclusively demonstrates that the forward-looking cost mechanism should not be used to determine rural company support and that only an embedded cost mechanism will provide sufficient support for rural carriers. *We disagree*. While the Rural Task Force demonstrated the inappropriateness of using input values designed for non-rural carriers to determine support for rural carriers, we do not find that its analysis

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15/ *White Paper #4* at 9-10.

16/ *Id.*

17/ *Id.*

justifies a reversal of the Commission's position with respect to the use of forward-looking cost as a general matter. 18/

4. *Real-World Economic Decisions Are Driven By Forward-Looking Costs, Not Embedded Costs*. Finally, the rural ILECs and their supporters ignore a century of economic thinking (and a solid line of Supreme Court and FCC precedents) 19/ by mischaracterizing embedded costs as "actual costs" and deriding forward-looking economic costs as "hypothetical." 20/ In reality, forward-looking economic costs are more "actual" than embedded book costs. Consider this example: you buy an insurance policy on your home, which is then destroyed by fire. How would you prefer to be compensated by the insurance company – based on the costs that the builder incurred to construct the house twenty years ago, or based on what it actually will cost to rebuild the house today? The latter is obviously the true measure of the house's value, as all serious economists and most homeowners recognize. 21/ Indeed, all five of the current FCC Commissioners recently concluded

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18/ *Federal-State Joint Board on Universal Service*, Fourteenth Report and Order, 16 FCC Rcd 11244, 11311-12, ¶¶ 174-75 (2001) ("*RTF Order*") (emphasis added, citations omitted, subsequent history omitted).

19/ *See An Idea Whose Time Has Come* at 9-12 (demonstrating the fallacy of rural ILEC contentions that forward-looking economic costs are not "real"). *See also Verizon v. FCC*, 535 U.S. 467 (2002); *Duquesne Light Co. v. Barasch*, 488 U.S. 299 (1989); *FPC v. Hope Natural Gas*, 320 U.S. 591 (1944); *Texas Office of Public Utility Counsel v. FCC*, 183 F.3d 393, 412 (5th Cir. 1999) (affirming that forward-looking support satisfies statutory "sufficiency" criterion).

20/ ICORE Companies Comments at 4 (rural ILECs "do not provide universal service using hypothetical networks, nor do they write theoretical checks to pay for forward looking economic costs"); ACS of Alaska, Inc. Comments at 10 (deriding FLEC as unable to accurately predict cost among diverse rural carriers).

21/ Even the insurance company would clearly prefer to pay a claim based on today's cost of rebuilding the house if the alternative – paying based on the original builder's construction cost – exposed the company to the risk of paying for a highly inefficient, excessively costly construction job.

that "it is forward-looking costs, not historical costs, that are relevant in setting prices in competitive markets." 22/

5. *Restricting Support Available to Competitive ETCs Would Distort the Marketplace and Harm Rural Consumers*. The Joint Board should reject the arguments of those who contend that competitive ETCs should receive less funding than ILECs serving the same areas – either based on the competitive ETCs' own embedded costs, 23/ or based on some other methodology but in any case less than or equal to ILEC per-line support. 24/ Western Wireless has already explained that establishing a separate and unequal system for funding CETCs (1) would fail to control fund growth, given that ILECs (not CETCs) are the principal cause of fund growth; (2) would violate the Communications Act's mandate of fund portability; and (3) by departing from the principle of competitive neutrality, would interfere with marketplace dynamics and harm rural consumers. 25/ Western Wireless concurs with commenters as diverse as USTA, AT&T, and the New York State Department of Public Service, all of whom agree that the same amounts of support

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22/ *Review of the Commission's Rules Regarding the Pricing of Unbundled Network Elements and the Resale of Services by Incumbent Local Exchange Carriers*, Notice of Proposed Rulemaking, 18 FCC Rcd 18495, ¶ 32 (2003) ("*TELRIC NPRM*"). *See also id.*, Separate Statement of Commissioner Kevin Martin.

23/ *See, e.g.,* OPASTCO Comments at 12-13; Fred Williamson Comments at 15-18; GVNW Comments at 16; ITC Comments at 2-3; RICA Comments at 2-3.

24/ *See, e.g.,* NASUCA Comments at 34; SBC Comments at 7.

25/ *See* Western Wireless Comments at 6-12. *See also* Rural Cellular Association/Alliance of Rural CMRS Carriers Comments, CC Docket No. 96-45 (filed Aug. 6, 2004), at 9-10 & Exh. 1 (analyzing responsibility of competitive ETCs and ILECs, respectively, for high-cost fund growth).

per-customer connection must be disbursed to all ETCs competing to serve a given geographic area. 26/

In sum, Western Wireless and other wireless representatives have presented serious and thoughtful proposals for comprehensive, consumer-oriented reform of the rural universal service funding system. Western Wireless looks forward to working with the Joint Board to develop a new, forward-looking universal service system that will be predictable, sustainable, and pro-competitive, as the Act requires.

Respectfully submitted,

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26/ *See* USTA Comments at 9; NYS DPS Comments at 2; Prepared Testimony of Joel Lubin on Behalf of AT&T (Joint Board En Banc Forum on High-Cost Universal Service Support, Nashville, Tenn., Nov. 17, 2004) at 4-6. *Accord*, GCI Comments at 15; CTIA Comments at 14.